IT 96-11
Tax Type: INCOME TAX
Issue: Unitary Apportionment
1005 Penalty (Reasonable Cause Issue)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS,	)	
	)	
v.	)	No.
	)	FEIN:
TAXPAYER, **et al.**,	)	
	)	
Taxpayer.	)	

FINAL ADMINISTRATIVE DECISION

Appearances: Fred O. Marcus & Jordan M. Goodman, Horwood, Marcus & Braun, Chtrd., Chicago, for taxpayer; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter involves the Department of Revenue's ("Department's") determination that seven related taxpayers should be comprised as a single unitary business group for purposes of filing Illinois income tax returns. The Department made that determination following an audit of TAXPAYER ("TAXPAYER") and certain of its subsidiaries for tax years ending 12/31/87 and 12/31/88. The TAXPAYER subsidiaries whose returns were reviewed during this audit included: INSURANCE COMPANY #1 ("INSURANCE COMPANY #1"); INSURANCE COMPANY #2 ("INSURANCE COMPANY #2"); INSURANCE COMPANY #3 "(INSURANCE COMPANY #3"); INSURANCE COMPANY #4 ("INSURANCE COMPANY #4"); INSURANCE COMPANY #5 ("INSURANCE COMPANY #5"); and INSURANCE COMPANY #6 ("INSURANCE COMPANY #6"). TAXPAYER and the subsidiaries identified in this paragraph are the taxpayers in this consolidated matter.

The Department also determined that three non-resident TAXPAYER subsidiaries should be included in the proposed unitary business group. Those subsidiaries were SURPLUS #1 ("SURPLUS #1"), SURPLUS #2 ("SURPLUS #2"), and SURPLUS #3 ("SURPLUS #3"). INSURANCE COMPANY #1, SURPLUS #2, and SURPLUS #3 are not taxpayers in this matter.

On January 21, 1992, as a result of the audit, the Department issued separate Notices of Deficiency ("NODs") to INSURANCE COMPANY #1, INSURANCE COMPANY #2, INSURANCE COMPANY #3, INSURANCE COMPANY #4, INSURANCE COMPANY #5, and INSURANCE COMPANY #6. The NODs proposed to assess corporate income and replacement tax, penalties, and interest against those taxpayers. The Department also issued a Notice of Overassessment to TAXPAYER, notifying it that, as a result of the proposed use of the combined apportionment method, TAXPAYER's tax liability for the tax years had decreased. Each of the taxpayers protested the NODs and requested a hearing.

A hearing on taxpayers' consolidated protests was held at the Department's Office of Administrative Hearings on March 17, 1994. At hearing, the parties offered into evidence a written Stipulation of Facts ("Stip.") and a Stipulated Exhibit List ("Stip. Ex."), which exhibits consisted of taxpayers' books and records and the Department's audit workpapers. The Department also offered additional documentary evidence, consisting of taxpayers' books and records, and taxpayer also offered the testimony of three witnesses, WITNESS #1 (Senior Vice-President and Treasurer for TAXPAYER), WITNESS #3 (Chairman and former President of SURPLUS #2), and WITNESS #2 (Tax Manager for taxpayers' corporate parent, PARENT ("PARENT")). After hearing, the parties submitted memoranda detailing their arguments.

Upon due consideration, the underlying recommendation of the administrative law judge who presided at hearing cannot be accepted in its entirety. Although the conclusion was that the assessment be upheld, the recommended decision did not, I believe, set forth sufficient findings of fact necessary to reach that ultimate conclusion. Additionally, and while the recommended decision included findings of fact and conclusions of law regarding the primary issue in this matter, the administrative law judge did not, in my view, phrase the issue properly. *Compare* Recommendation For Disposition at 2 (statement of issues) *with* Department's Brief, p. 10 *and* Tr. pp. 53-54 (taxpayers' opening statement), 214 (counsel for taxpayers argued that the only issue before the ALJ was whether the surplus companies were engaged in a unitary business with taxpayers' property and casualty companies).

When writing this final decision, I remain mindful of my responsibilities to taxpayers as well as to the State. This decision shall be based solely on competent evidence produced at hearing and those legal conclusions which can be fairly drawn from the evidence. I have reviewed with particularity all evidence offered and admitted by the parties. Additionally, I have apprised myself of the pertinent sections of law relevant to the issues presented at hearing. I have considered the entire transcript of record, including the testimony of witnesses and the argument of counsel.

A sufficient record of proceedings was made to permit the appropriate review and issuance of this final administrative decision pursuant to 86 Ill. Admin. Code § 200.165 (1996). *See also* Highland Park Convalescent Home v. Health Facilities Planning Comm., 217 Ill. App. 3d 1088 (1991). I am including in this final decision specific findings of fact and conclusions of law.

Issues:

1. Whether taxpayers' surplus lines insurance companies were engaged in a unitary business with taxpayers' other, concededly unitary, insurance companies.
2. Whether the Department properly included the income of taxpayers' surplus lines insurance companies in the denominator of taxpayers' unitary business group's apportionment fraction.

3. Whether § 1005 penalties were properly assessed against taxpayers.

Findings Of Fact:

Findings Regarding Taxpayers' Basic Corporate Structure and Organization

1. TAXPAYER is an Ohio corporation doing business in Illinois. *See* Stip. ¶¶ 2-3.

2. TAXPAYER is a wholly-owned subsidiary of TAXPAYER Holding Corporation, which is wholly owned by PARENT ("PARENT"). Stip. ¶ 4; Stip. Ex. B (PARENT's corporate organizational chart). PARENT is the direct or indirect corporate parent of all the taxpayers in this matter. Stip. Ex. B.

3. TAXPAYER is the direct corporate parent of, among other companies: INSURANCE COMPANY #1, SURPLUS #1, INSURANCE COMPANY #2, INSURANCE COMPANY #3, SURPLUS #2, INSURANCE COMPANY #4, INSURANCE COMPANY #5, and INSURANCE COMPANY #6. Stip. Ex. B.

4. INSURANCE COMPANY #5 directly owns 100% of SURPLUS #3' outstanding common stock. Stip. Ex. H (SURPLUS #3' 1987 & 1988 Annual Statements, Notes to Financial Statements ("Notes"),[1] ¶ 4(a)); Stip. Ex. B.

5. SURPLUS #2 owns 100% of COMPANY #7's outstanding common stock. Stip. Ex. H, (COMPANY #7's 1987 & 1988 Annual Statements, Notes, ¶ 4(a)); Stip. Ex. B.

6. TAXPAYER, INSURANCE COMPANY #1, INSURANCE COMPANY #2, INSURANCE COMPANY #3, INSURANCE COMPANY #5, and INSURANCE COMPANY #6 (hereinafter, "the INSURANCE COMPANY #6") are engaged in the insurance business. *See* Stip. ¶ 4; Stip. Ex. B (each P&C company identified as an "Insurer" in PARENT's corporate organizational chart). Those INSURANCE COMPANY #6 contract to provide insurance generally classified as property and casualty insurance. Stip. ¶ 4; *see also* 215 **ILCS** 5/4 (under the Illinois Insurance Code, insurance and insurance business is divided into two classes: (1) life, accident and health; and (2) casualty, fidelity and surety).

7. COMPANY #7 is engaged in the insurance business. Stip. Ex. B (COMPANY #7 identified as an "Insurer" in PARENT's corporate organizational chart). It contracts to provide insurance generally classified as property and casualty insurance. Stip. ¶ 18.

8. INSURANCE COMPANY #4 is engaged in the insurance business. Stip. Ex. I, PARENT's 1987 Form 10-K, p. 9; Stip. Ex. B (INSURANCE COMPANY #4 identified as an "Insurer" in PARENT's corporate organizational chart). INSURANCE COMPANY #4 contracts to provide a variety of insurance products, including annuities, whole life and term life insurance. Stip. Ex. I, PARENT's 1987 Form 10-K, p. 9.

9. SURPLUS #1, SURPLUS #2,[2] and SURPLUS #3 (hereinafter "the Surplus Companies") are engaged in the insurance business. Stip. ¶¶ 6, 21, 29-31; Stip. Ex. B (each Surplus Company identified as an "Insurer" in PARENT's corporate organizational chart);

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1. The Notes to Financial Statements ("Notes") section of each Annual Statement contained in Stip. Ex. H begins on p. 17 of each Statement.

Stip. Ex. G (example of insurance policy written by the Surplus Companies); *see also* 215 **ILCS** 5/445. The Surplus Companies contract to provide insurance generally classified as property and casualty insurance. Stip. ¶¶ 27-31; *see also*, Stip. Ex. I, PARENT's 1987 Form 10-K, pp. 26-27 (PARENT included statement about the profitability of its surplus lines insurance companies under the main heading of, "Results of Operations - Three Years Ended December 31, 1987", and the subheading, "Property and Casualty Insurance - Underwriting").

10. Each of the Surplus Companies received income from premiums for insurance written upon property or risk in Illinois during the tax years audited. *See* Stip. ¶ 21; Stip. Ex. C (auditor's workpapers).

11. None of the Surplus Companies filed Illinois income tax or corporate replacement tax returns during the tax years. Stip. Ex. C (auditor-prepared schedule titled, "Unitary Audit Result Input Form Part II", (unnumbered) p. 15 of that exhibit).

12. TAXPAYER and the INSURANCE COMPANY #6 engaged in unitary business activities, as defined in section 1501(a)(27) of the IITA, and those companies comprised a unitary business group during the audit period. Stip. ¶¶ 10, 33.

13. At hearing, counsel for taxpayers stated unequivocally that taxpayers were not contesting the inclusion of COMPANY #7 into the unitary business group proposed by the Department. Tr. pp. 213-15.

14. Taxpayers introduced no evidence, either documentary or testimonial, that INSURANCE COMPANY #4 was not part of the proposed unitary business group.

Facts Regarding the Distinctions and Similarities of the INSURANCE COMPANY #6 and the Surplus Companies

15. The INSURANCE COMPANY #6 are licensed and regulated by the states in which they are admitted do business. Stip. ¶ 12.

16. The INSURANCE COMPANY #6 and INSURANCE COMPANY #4 are registered with the Illinois Department of Insurance ("IDI") (Stip. ¶ 12), and annually report to that agency the total amount of premiums collected for insurance written upon property or risk in Illinois. *See* Stip. ¶ 12.

17. The Surplus Companies are licensed to do business only in Delaware, and are otherwise not directly regulated by the states wherein the property or risks they insure are situated. *See* Stip. ¶¶ 20-24. The Surplus Companies are not subject to rate and policy regulation by the IDI, as are the INSURANCE COMPANY #6. Stip. ¶ 22. The regulation of surplus lines insurance business is accomplished through the direct regulation of surplus lines insurance brokers, called "producers" under Illinois law. 215 **ILCS** 5/445 (*formerly* Ill. Rev. Stat. ch. 73, ¶ 1057 (1987)); *see also* Stip. ¶ 23.

18. While Illinois does not directly regulate the Surplus Companies' activities, the Director of the IDI has the authority to declare a surplus lines company ineligible to write policies for property or risks in Illinois. 215 **ILCS** 5/445(9); Tr. pp. 184-86 (WITNESS #3).

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[2]. SURPLUS #2 had previously been named SURPLUS #2 Insurance Company. Tr. p. 203 (WITNESS #3); *see also* Stip. Ex. J (service agreement between PARENT and Great SURPLUS #2 Insurance Co.).

19. The Surplus Companies wrote policies for classes of insurance also written by the INSURANCE COMPANY #6. *See* Stip. ¶¶ 11, 27-31; Tr. p. 145 (WITNESS #1).

20. After PARENT purchased TAXPAYER and its subsidiaries in 1973 (*see* Stip. Ex. I, PARENT's 1987 Annual Report, p. 2), it organized those subsidiaries, or allowed them to remain organized, so that the companies could conduct business in groups of "risk pools". Stip. ¶¶ 19, 36; Tr. pp. 72-73 (WITNESS #1).

21. A risk pool is a group of insurance companies, either related through common ownership or not, which agree to share the total liability for a group of insurance policies written by the various members of the group. Tr. p. 73 (WITNESS #1). Each company in a risk pool was a party to a reinsurance pooling agreement which, *inter alia*, transferred all direct insurance liabilities of the members to the dominant company in the pool. Stip. Ex. H (1987 and 1988 Annual Statements, Notes, ¶¶ 18 or 20 (depending on Annual Statement)).

22. Each of the Surplus Companies is assigned to one of the risk pools. *See* Stip. ¶ 19; Tr. pp. 72-76 (WITNESS #1).

23. SURPLUS #3 is part of the INSURANCE COMPANY #5 risk pool. Stip. Ex. H (SURPLUS #3' 1987 & 1988 Annual Statements, Notes, ¶¶ 18, 20, respectively); *see also*, Stip. ¶ 26; Tr. pp. 72-73, 100 (WITNESS #1); Taxpayers' Brief, pp. 41-42.

24. SURPLUS #1 is part of the TAXPAYER risk pool. Stip. Ex. H (SURPLUS #1' 1987 & 1988 Annual Statements, Notes, ¶¶ 18, 20, respectively); Tr. pp. 75-76 (WITNESS #1); Taxpayers' Brief, p. 41.

25. SURPLUS #2 and COMPANY #7 make up the SURPLUS #2 pool. Tr. pp. 77-78 (WITNESS #1), p. 162 (WITNESS #3); Taxpayers' Brief, p. 41.

26. The dominant company in each risk pool managed the day-to-day affairs of the pool. *See* Tr. p. 76 (WITNESS #1).

27. Each of the six pools wrote, underwrote, priced and marketed insurance products, maintained agent and broker relationships, accounted for premiums and handled claims within the respective groups and under the management of the respective groups. Stip. ¶¶ 19, 36.

28. TAXPAYER incorporated SURPLUS #1 to obtain a share of the surplus lines business available to be written in the marketplace. *See* Tr. pp. 78-79 (WITNESS #1); *see also* Tr. pp. 149-50, 179-80, 182-83 (WITNESS #3).

29. SURPLUS #1 would not be able to function without the services provided by TAXPAYER because SURPLUS #1 had no employees. Tr. pp. 126-27 (WITNESS #1).

30. SURPLUS #2 was the dominant company in its pool, and SURPLUS #2 personnel managed the day-to-day affairs of the pool. Tr. p. 78 (WITNESS #1); *see also* Stip. ¶¶ 19, 36.

31. SURPLUS #2 formed COMPANY #7 so the SURPLUS #2 pool could write policies for risks SURPLUS #2 could not write, because it was a surplus lines carrier. *See* Tr. pp. 160-61 (WITNESS #3).

32. SURPLUS #2 guaranteed some of the policies written by COMPANY #7. Stip. Ex. H (SURPLUS #2' 1987 Annual Statement, Notes, ¶ 4(e)).

33. COMPANY #7 obtained its business through agents who did business with SURPLUS #2. Tr. pp. 187-89 (WITNESS #3).

34. COMPANY #7 would not be able to function without SURPLUS #2, because COMPANY #7 had no employees. Tr. pp. 188, 201 (WITNESS #3).

35. The Surplus Companies are not engaged in the business of wholesaling, and the INSURANCE COMPANY #6 are not engaged in the business of retailing. Rather, the Surplus Companies, INSURANCE COMPANY #4, and the INSURANCE COMPANY #6 were all engaged in the same general line of business, i.e., the insurance business. *See, e.g.*, Stip. Ex. B (taxpayers and taxpayers' Surplus Companies identified as "Insurer[s]" in PARENT's corporate organizational chart); 35 **ILCS** 5/1501(a)(27).

36. Taxpayers' Surplus Companies were formed to act as a supplement to taxpayers' standard lines or licensed companies. Tr. pp. 149, 151 (WITNESS #3); Department's Brief, Errata sheet, p. 5.

37. Each of the Surplus Companies has nexus with Illinois for purposes of the IITA because each: received business income from premiums for surplus lines insurance written upon property or risks in Illinois (*see* Stip. ¶ 21); was required to submit every contract for surplus lines insurance written upon risks or property in Illinois during the audit period to the Surplus Line Association of Illinois (215 **ILCS** 5/445); worked within a risk group with at least one of taxpayers' INSURANCE COMPANY #6, which INSURANCE COMPANY #6 taxpayers admitted were members of a unitary business group during the tax years at issue. *See* Stip. ¶¶ 19, 36.

Facts Regarding Evidence Of Strong Centralized Management

38. TAXPAYER was the direct or indirect parent of all the taxpayers or Surplus Companies involved in these consolidated matters. *See, e.g.*, Stip. Ex. B (PARENT's corporate organizational chart).

39. The INSURANCE COMPANY #6, INSURANCE COMPANY #4 and the Surplus Companies had, to a large degree, common officers and directors. Stip. ¶ 34; Tr. p. 21 (Murray).

40. Common officers and/or directors exercised management or other authority over taxpayers' INSURANCE COMPANY #6 and Surplus Companies. Stip. ¶ 34.

41. All companies which were members of the TAXPAYER pool shared the following centralized management and support systems: underwriting, accounting, personnel, cash management, administrative services such as centralized purchasing, services for leasing real and personal property, loss prevention, marketing, claims, and data processing. *See* Stip. 19; Tr. pp. 79-81 (WITNESS #1);

42. TAXPAYER also provided services for the SURPLUS #2 pool, which services included purchasing supplies, data processing, legal services, personnel services (involving pension administration). Tr. pp. 81-84 (WITNESS #1).

43. The SURPLUS #2 pool benefitted by having training, actuary, administrative, legal, purchasing and computer services performed by TAXPAYER. Tr. p. 193 (WITNESS #3).

44. Each of the 1987 & 1988 Annual Statements for TAXPAYER, COMPANY #7, INSURANCE COMPANY #5, and the Surplus Companies, contain the following statements under the headings "Notes to Financial Statements", "Information Concerning Parent, Subsidiaries and Affiliates":

> Management or service contracts and all cost-sharing arrangements involving the Company or any affiliated insurer:
>
> 1. Affiliated insurance companies have contracts with American Money Management Corporation (an affiliate) which, subject to the control of the Finance Committees of the companies, provide for management and accounting services related to the investment portfolios.
>
> 2. Certain administrative services are provided to both insurance and non-insurance affiliates through the use of shared facilities and personnel, for which costs are allocated on the basis of usage.
>
> 3. Certain administrative, management, accounting data processing, underwriting, claim and collection services are provided under agreements between affiliates.

Stip. Ex. H (Notes, ¶ 4(f) of each Annual Statement).

45. The INSURANCE COMPANY #6, INSURANCE COMPANY #4, and the Surplus Companies used the services of the same investment management company, which was another PARENT subsidiary. *See, e.g.*, Stip. Ex. H (Notes, ¶ 4(f)(1) of each Annual Statement); Tr. p. 96 (WITNESS #1); *see also* Stip. Ex. I (PARENT's 1987 and 1988 Annual Reports, pp. 10-11, and p. 13, respectively, describe PARENT's philosophy regarding its centralized management of its insurance groups' investment portfolio).

46. Because the profitability of PARENT's insurance subsidiaries depended on two main areas of operation: underwriting insurance and investments of assets (Stip. Ex. I, PARENT's 1987 10-K, p. 3; Stip. Ex. I, PARENT's 1988 10-K, p. 2), PARENT, through its subsidiary, MANAGEMENT CORP., exercised strong centralized control over its insurance subsidiaries' investment portfolios. Stip. Ex. H (Notes, ¶ 4(f) of each Annual Statement); Stip. Ex. I, PARENT's 1987 Annual Report, p. 1 (in a description of PARENT's separate businesses, PARENT described the services offered by MANAGEMENT CORP. as "investment of funds for PARENT and subsidiaries"), pp. 10-11 (PARENT investment philosophy set forth).

47. The INSURANCE COMPANY #6, INSURANCE COMPANY #4, and the Surplus Companies made inter-company sales of securities to each other and to other PARENT subsidiaries, pursuant to the centralized management of PARENT's subsidiaries' investments. Department Ex. No. 1 (PARENT computer records reflecting regular inter-company transfers of securities, and regular inter-company dividend payments between PARENT subsidiaries); Stip. Ex. I, PARENT's 1987 10-K, p. 3; Stip. Ex. I, PARENT's 1988 10-K, p. 2; Tr. pp. 95-98 (WITNESS #1). TAXPAYER engaged in loan transactions with at least one of the

Surplus Companies during the audit period. *See, e.g.*, Stip. Ex. H (TAXPAYER's 1987 Annual Statement, p. 17.2 (at various times during 1987, TAXPAYER took short-term advances from, and made repayments to, SURPLUS #2, which loans totaled over 20 million dollars)).

48. In addition to providing centralized investment services to all PARENT subsidiaries, PARENT also entered into agreements to provide general services to each of the Surplus Companies. Stip Ex. J (copies of service agreements); *see also, e.g.*, Stip. Ex. I, PARENT's 1987 Annual Report, p. 27 ("Transactions with Affiliates").

49. The service agreements between PARENT and the Surplus Companies, which agreements were admitted into evidence as Stip. Ex. J, were in effect during the audit period. Stip. ¶ 37.

50. Each of the service agreements between the Surplus Companies and PARENT also contain the following provisions:

> WHEREAS, PARENT, on behalf of itself and its subsidiaries, including but not limited to TAXPAYER, MANAGEMENT CORP., . . . have the staff and equipment capabilities to provide certain administrative services to [the subsidiary], and
>
> WHEREAS, [the subsidiary] from time to time may have need of said services, and
>
> NOW, THEREFORE, in consideration of the foregoing and the several promises, covenants, conditions and stipulations contained herein, the parties agree as follows:
>
> 1. PARENT agrees to furnish and [the subsidiary] agrees to accept on the following terms and conditions, such printing, office duplicating, telecommunications, purchasing, personnel, data processing, administrative, consultative and other services performed by PARENT in connection with the needs of [the subsidiary] as requested by [the subsidiary].

Stip. Ex. J (each agreement).

51. While the parties stipulated that "PARENT [i.e., PARENT] entered into service agreements to provide general services to each of the Surplus line insurance companies . . . ." (Stip. ¶ 37), the agreements themselves reveal that either PARENT or its subsidiaries would render the services detailed in the agreements. Stip. Ex. J (page 1 of each agreement).

52. Costs associated with the services provided to the Surplus Companies by PARENT, or by PARENT subsidiaries such as TAXPAYER, pursuant to the service agreements, were allocated to PARENT through the centralized accounting system PARENT used for all its subsidiaries. Stip. Ex. H (Notes, ¶ 4(f) of each Annual Statement); Stip Ex. J (subsection II ("Fees") of each agreement); Tr. pp. 83-84 (WITNESS #1).

53. While taxpayers offered testimony to prove that the services PARENT or its other subsidiaries agreed to perform for the Surplus Companies, were not, in fact, performed, that testimony was not corroborated by any documentary evidence of record, and it was inconsistent with taxpayers' own books and records (*see, e.g.*, Stip. Ex. H, Notes, ¶ 4(f) of each Annual Statement).

54. Taxpayers' Surplus Companies were formed to act as a supplement to taxpayers' standard lines or licensed insurance companies. *See* Tr. pp. 149, 151, (WITNESS #3); Department's Brief, Errata sheet, p. 5.

55. WITNESS #3's opinion testimony that the Surplus Companies are wholesalers is inconsistent with taxpayer's own books and records (*see* Stip. Exs. F & G), and it is inconsistent with the common understanding of the concept of wholesaling.

Facts Regarding the Department's Audit

56. TAXPAYER, INSURANCE COMPANY #1, INSURANCE COMPANY #2, INSURANCE COMPANY #3, INSURANCE COMPANY #4, INSURANCE COMPANY #5, and INSURANCE COMPANY #6 each filed separate Illinois corporate income and replacement tax returns for the tax years at issue. Stip. ¶ 3.

57. The Department issued NODs to taxpayers after the Department's auditor determined that taxpayers were improperly reporting income separately, and that tax should have been reported and calculated using the combined apportionment method for taxpayers' unitary business group. *See* Stip. ¶ 3; Stip. Ex. C (pp. 1-3 (Auditor's Comments), pp. 23-29 (Department schedules titled "Explanation of Adjustments")).

58. The parties offered the Department auditor's workpapers into evidence as Stipulation Exhibit C, which exhibit was admitted into evidence. Additionally, the auditor testified as part of the Department's *prima facie* case in this matter. *See* Tr. pp. 6-52.

59. The auditor's determination regarding the composition of the unitary business group proposed for taxpayers was based on his review of taxpayers books and records, including taxpayers' subsidiaries' annual statements, taxpayers' parent's annual reports and 10-Ks, federal and state tax returns filed for the audit period, and corporate minutes. *See, respectively* Stip. Exs. H (annual statements), I (PARENT's annual reports and Forms 10-K for 1987 and 1988); Tr. pp. 18-19 (Murray testified that he reviewed taxpayer's federal and state 1120s), 21, 31 (Murray testified that he also reviewed taxpayer's corporate minutes of various meetings when making his determination that the taxpayers and the Surplus Companies were subjected to the exercise of strong centralized management); *see also* Department Ex. No. 2 (taxpayers' and subsidiaries' corporate minutes).

60. The books and records reviewed by the auditor contain statements which support his determination that taxpayers and the Surplus Companies: shared common ownership (*see* Stip. Exs. H & I); were in the same general line of business or were vertically structured (*see* Stip. Exs. H & I); and were subjected to the exercise of strong centralized management authority. Department Ex. Nos. 1 & 2; Stip. Ex. H; Tr. pp. 43-47 (auditor testified that committee meeting minutes in which common directors authorized inter-company sales of securities between taxpayers and the Surplus Companies (which sales are reflected in Department Ex. 1), were part of the bases for his determination that the taxpayers' records reflected the actual exercise of strong, centralized management among the proposed unitary group).

61. During cross-examination of the Department's auditor, taxpayers sought to undermine the reasonableness of the Department's determination of the proposed unitary group by showing that the auditor failed to investigate the accuracy of statements contained in taxpayers' and the Surplus Companies' books and records. Tr. pp. 35, 48-52.

62. Taxpayer's challenge to the reasonableness of the Department's proposal to combine taxpayers and their Surplus Companies into a unitary business group was not supported by any credible evidence closely identified with taxpayers' books and records. *See* Taxpayers' Brief, p. 53.

Facts Regarding the Formula Used to Apportion Taxpayers' Unitary Business Group's Business Income

63. The Department used the combined apportionment method when calculating the amount of tax proposed in the NODs issued to taxpayers. Stip. Ex. C (Auditor's Comments, pp. 1-3); Tr. p. 10 (Department's opening statement).

64. Using the combined apportionment method, the Department first added together the federal income reported by each member of the proposed unitary business group. *See* Stip. Ex. C (Auditor's Comments, pp. 2-3 (headings titled "Unitary Business Income" and "Factors")).

65. The Department auditor included the Surplus Companies' direct premiums written everywhere in the denominator of the apportionment fraction for the unitary business group. *Id.*; Stip. Ex. C (auditor's workpapers, pp. 23-29 (Department schedules titled, "Explanation of Adjustments")).

66. The Department did not issue NODs to the Surplus Companies. *See* Stip. Ex. D (NODs and Protests); Stip. Ex. C (Auditor's Comments, pp. 1-3).

67. No NOD issued in this matter was calculated by including in the numerator of an apportionment fraction the amount of direct premiums written by the Surplus Companies for surplus lines insurance upon property or risk in Illinois. Stip. Ex. C (Auditor's Comments, pp. 1-3).

68. The Surplus Companies' business income was never subjected to Illinois income tax. *See* Stip. Exs. C & D.

Conclusions of Law:

The primary issue to be determined in this matter is whether taxpayers' Surplus Companies are engaged in a unitary business operation with their INSURANCE COMPANY #6. That issue requires a factual determination. Citizens Utility Co. v. Department of Revenue, 111 Ill. 2d 32, 47, 488 N.E.2d 984, 990 (1986). When making that factual determination, I acknowledge that the Department established the *prima facie* correctness of its determination that taxpayers were engaged in a unitary business by introducing the NODs into evidence. 35 **ILCS** 5/904(a) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 9-904(a)(1987)). While the definition section of the Illinois Income Tax Act ("IITA") sets forth the statutory criteria an auditor must use when making a determination whether a unitary group exists (35 **ILCS** 5/1501(a)(27)), that statutory definition does not in any way affect the presumptive effect section 904(a) affords to the Department's determination that such a group exists.

Notwithstanding the clear statutory language of § 904(a), the ALJ began his reasoning in this matter by citing Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983), for the proposition that "[p]roposed adjustments in a notice of deficiency are prima facie correct *so long as the Department of Revenue meets some standard of reasonableness in arriving at its proposed adjustments*." Recommended

Decision at 8 (emphasis added). While that statement is an accurate recitation of a ruling in that case, the question whether an audit determination meets minimum standards of reasonableness ought not be posed until a taxpayer has introduced credible evidence that the tax adjustment proposed *failed* to meet such standards. Vitale v. Department of Revenue, 118 Ill. App. 3d at 213.

Moreover, a taxpayer's mere argument, or uncorroborated testimony that an audit adjustment is incorrect or unreasonable, is insufficient to rebut the *prima facie* correctness of the Department's proposed adjustments. Instead, the Department's determinations are rebutted only after a taxpayer introduces documentary evidence, or evidence which is consistent, probable and identified with taxpayer's books and records, showing that the Department's determination is incorrect. A. R. Barnes v. Department of Revenue, 173 Ill. App. 3d 826, 835 (1st Dist. 1988) (a taxpayer's oral testimony, without sufficient corroborative evidence, will not rebut the Department's *prima facie* case); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981) (even taxpayers who are not businessmen must present documentary evidence which supports their claim that state income tax is not due). While I acknowledge that the Department bears the ultimate burden to prove its case by competent evidence in those instances where its *prima facie* case has been rebutted with books and records (*see* Goldfarb v. Department of Revenue, 411 Ill. 573, 580 (1952)), I belabor the point here to eliminate any suggestion that the Department is somehow obliged to prove the reasonableness of its audit determinations *before* the statutory presumption of correctness attaches.

Issue 1

The IITA provides a definition of "unitary business group." A unitary business group is:

> a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. The group will not include those members whose business activity outside the United States is 80% or more of any such member's total business activity . . . . Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either case, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

35 **ILCS** 1501(a)(27) (1994) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 15-1501(a)(28) (1985)). The Department's regulations also address the criteria to be used when determining whether separate corporations are members of a unitary business group. 86 Ill. Admin. Code § 100.9700.

In this case, taxpayers do not dispute that common ownership exists between the INSURANCE COMPANY #6 and the Surplus Companies. TAXPAYER is the direct or indirect parent of all of the taxpayers and Surplus Companies combined into the proposed unitary business group. Stip. Ex. B (PARENT's corporate organizational chart). Taxpayers do, however, dispute that the INSURANCE COMPANY #6 and the Surplus Companies are engaged in the same line of business. Taxpayers' Brief, pp. 1-2.

Taxpayers assert that their INSURANCE COMPANY #6 and their Surplus Companies should not be considered to be in the same general line of business because of the differences in the way the companies conduct business and are regulated. *See, e.g.*, Taxpayers' Brief, p. 31. The differences between the INSURANCE COMPANY #6 and the Surplus Companies do not, however, render the Surplus Companies wholesalers, and the INSURANCE COMPANY #6 retailers. As a practical matter, companies engaged in the business of providing services cannot be "wholesalers". Wholesalers sell goods to retailers, who then resell the same goods to consumers. *See, e.g.*, Black's Law Dictionary 1432 (5th ed. 1979) (definition of "wholesaler"). In contrast, taxpayers' insurance contracts show that both their INSURANCE COMPANY #6 and their Surplus Companies are primarily engaged in the business of contracting directly with customers to write insurance for customers upon certain risks or property. Stip. Exs. F & G.

Taxpayers' witnesses' ability to distinguish the class or type of risk insured cannot and does not obviate the fact that all of the Surplus Companies and all of the INSURANCE COMPANY #6 are engaged in the insurance business, one of the general business lines specifically identified in section 1501(a)(27) of the IITA. 35 **ILCS** 5/1501(a)(27); *see also* 86 Ill. Admin. Code § 100.9700(h)(3)-(4). I conclude that taxpayers' INSURANCE COMPANY #6, their Surplus Companies and INSURANCE COMPANY #4 were all engaged in the same general line of business.[3] Each is engaged in the insurance business. *See, e.g.*, Stip. Ex. B (PARENT's organizational chart); Stip. Ex. H (Annual Statements); Stip. Ex. I (1987 & 1988 10-Ks, p. 1 of each); 215 **ILCS** 5/4.

Section 1501(a)(27) of the IITA provides that members of a unitary group must be functionally integrated through the exercise of strong centralized management. Through their stipulations, taxpayers conceded that their INSURANCE COMPANY #6 were functionally integrated through the exercise of strong centralized management. Stip. ¶ 33. Consistent with the substance of their clients' protest, and in response to a motion by counsel for the Department at the close of all the evidence, taxpayers' counsel both stated at hearing that taxpayers were not contesting the Department's inclusion of COMPANY #7 into the proposed unitary business group. Tr. pp. 213-14.[4] Taxpayers' counsels' clear and unequivocal statements at hearing constituted a judicial admission of the fact that

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3. While taxpayers argue that the INSURANCE COMPANY #6 and the Surplus Companies are not engaged in the same line of business, the relevant statutory inquiry is whether related companies are in the same *general* line of business. 35 **ILCS** 5/1501(a)(27).

4. Notwithstanding their statements at hearing, taxpayers' attorneys submit the argument that COMPANY #7 is not part of taxpayers' unitary business group. Taxpayers' Brief, pp. 18 n.4, 45 n.7. That argument is wholly inconsistent with taxpayers' judicial admission that they were not contesting that fact. Tr. pp. 213-14. Judicial admissions are conclusive upon the party making them, and cannot be controverted at trial or upon appeal. Brummet v. Farel, 217 Ill. App. 3d 264, 266-67 (1991) (included in the category of judicial admissions are admissions in pleadings, formal admissions in open court, stipulations and admissions pursuant to requests to admit).

In the recommended decision, the administrative law judge found that taxpayers' failure to protest COMPANY #7's inclusion into the unitary business group waived the issue. *See* Recommended Decision at 5 (finding of fact 10). While that finding is consistent with the language of Department hearing rule 200.120(b) as was then promulgated, that regulation has been updated recently, and the current version allows parties to assert, where allowed, positions not included in taxpayer's protest. *See* 86 Ill. Admin. Code § 200.120 (1996). Taxpayers' argument on this point was not waived because they failed to protest the issue, it was waived when their attorneys stated unequivocally at hearing that taxpayers were not contesting that particular fact. Tr. pp. 213-14.

COMPANY #7 was a member of the unitary business group during the relevant tax years. *See* Dora v. Indiana Insurance Co., 67 Ill. App. 3d 31, 32-33 (1979) (statements made by counsel at hearing can act as a judicial admission which binds client), *aff'd*, 78 Ill. 2d 376 (1980).[5]

The crux of taxpayers' argument against the proposed combination involves their assertion that the Surplus Companies cannot be included in the proposed unitary group with the INSURANCE COMPANY #6 because there was no exercise of strong centralized management between the INSURANCE COMPANY #6 and the Surplus Companies. *See, e.g.*, Taxpayers' Brief, p. 47. Taxpayers assert both that the Department failed to show any actual exercise of strong centralized management between them, and that taxpayers offered credible evidence showing that none was exerted. *Id.* After considering the stipulations of fact, taxpayers' books and records and the testimony of taxpayers' witnesses, particularly the evidence regarding the manner in which taxpayers and their related subsidiaries conducted business within risk pools, I conclude that taxpayers' arguments are wholly without merit.

The actual exercise of strong centralized management between taxpayers' INSURANCE COMPANY #6 and their Surplus Companies is plainly revealed by the evidence of record. Taxpayers stipulated that "the members of the unitary business group conducted their insurance business through six groups that were part of PARENT [PARENT] and its subsidiaries." Stip. ¶ 36; *see also* Stip. ¶ 19. Taxpayers' witnesses WITNESS #1 and WITNESS #3 both testified that each of taxpayers' Surplus Companies conducted business as a member of one of those risk pools. Tr. pp. 72-76, 100 (WITNESS #1), pp. 149-50, 179-80, 182-183 (WITNESS #3); Stip. ¶¶ 19, 36. SURPLUS #1 was a member of the TAXPAYER risk pool, SURPLUS #2 and COMPANY #7 were the sole members of the SURPLUS #2 pool, and SURPLUS #3 was a member of the INSURANCE COMPANY #5 risk pool. *See, e.g.*, Taxpayers' Brief, p. 41.

Taxpayers stipulated that each of the risk pools "wrote, underwrote, priced and marketed insurance products, maintained agent and broker relationships, accounted for premiums and handled claims within their respective groups and under the management of the respective groups." Each of the pools maintained reinsurance agreements by which all direct insurance liabilities of the companies in the pool were transferred to the dominant company. *See, e.g.*, Stip. Ex. H (Surplus Companies' 1987 & 1988 Annual Statements, Notes, ¶ 18 [or 20] of each Statement). Contrary to taxpayers' argument that the Department offered no evidence showing the actual exercise of strong centralized management, their Surplus Companies' own books and records clearly show that PARENT, or other PARENT subsidiaries, provided management, investment, accounting, legal, personnel, and other services as needed to each of the Surplus Companies. Stip. Ex. H (Surplus Companies' 1987 & 1988 Annual Statements, Notes, ¶ 4(f) of each Statement).

The service agreements between PARENT and the Surplus Companies reflect that PARENT, on its own or through its subsidiaries, agreed to provide essential services to the Surplus Companies. Stip. Ex. J. The Surplus Companies' Annual Statements state

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5. And even if their attorneys' statements at hearing did not constitute a judicial admission, the evidence clearly shows that SURPLUS #2 and COMPANY #7 were functionally integrated with each other, and were operated under the strong central management authority exercised by PARENT. *See, e.g.*, Stip. Ex. H (SURPLUS #2' 1987 & 1988 Annual Statements, Notes, ¶ 4(f) of each Statement); Stip. Ex. J (service agreements); Stip. ¶ 37. Additionally, WITNESS #3's testimony that the sole purpose for the surplus lines industry was to supplement the standard lines insurance companies (*see* Tr. pp. 149, 151) constitutes evidence that taxpayers' INSURANCE COMPANY #6 and their Surplus Companies were engaged in a vertically structured business. 35 **ILCS** 5/1501(a)(27).

that affiliates of the Surplus Companies, in fact, provided management, administrative, data processing, accounting and other services to the Surplus Companies, pursuant to existing agreements. *See, e.g.*, Stip. Ex. H (Surplus Companies' 1987 & 1988 Annual Statements, Notes, ¶ 4(f) of each, states, "[c]ertain administrative, management, accounting, data processing, underwriting, claim and collection services *are provided* under agreements between affiliates") (emphasis added); Stip. Ex. J.

In response to such clear statements in their clients' books and records, taxpayers' attorneys cite to WITNESS #1's uncorroborated testimony, and argue that the statements in the Surplus Companies' Annual Statements were inserted solely to satisfy certain (unidentified and undefined) reporting requirements. Taxpayers' Brief, p. 43. Similarly, counsel point to WITNESS #3's uncorroborated testimony, and argue that the service agreements between PARENT and the Surplus Companies were made solely to satisfy state insurance regulators. *Id.*, pp. 43-44. WITNESS #3's testimony regarding the reasons why PARENT entered into service agreements with its Surplus Companies (*see* Stip. Ex. J), and WITNESS #1's testimony regarding the reasons why certain entries were made in the Surplus Companies' Annual Statements, were used by counsel as proof that the centralized services described in taxpayers' books and records were *not* provided to the Surplus Companies. Taxpayers' Brief, pp. 43-44.

The problem with taxpayers' use of such testimony for that purpose is that such testimony is inconsistent with the literal accuracy of the statements in taxpayers' books and records. The Surplus Companies' Annual Statements do not state that affiliates "may, if necessary, provide services to the [Surplus Companies]" (*see* Stip. Ex. H (Surplus Companies' 1987 & 1988 Annual Statements, Notes, ¶ 4(f) of each Statement)), and the service agreements do not state that the agreements were being made as an inducement to obtain some grant from a state insurance department (*see* Stip. Ex. J). By making the argument, taxpayers' counsel call into question the accuracy of taxpayers' own books and records.

Entries in business records are admissible as evidence that the act, transaction, occurrence, or event described in the entries occurred. Illinois Supreme Court Rule 236;[6] *see also* Cleary and Graham, Handbook of Illinois Evidence 726-27 (6th ed. 1994) (the reason why business records are admissible as an exception to the hearsay rule is that a company's regular entries on its books and records are useless for business purposes if not accurate). The Surplus Companies' Annual Statements state that management, accounting, data processing, underwriting, and other services were provided by the Surplus Companies' affiliates. *See* Stip. Ex. H. If taxpayers' books and records entered into evidence in this matter are not accurate, they are not trustworthy, and no amount of testimony can help them in this administrative hearing. *See, e.g.*, A. R. Barnes v. Department of Revenue, 173 Ill. App. 3d 826, 835 (1988).

I conclude that the reason why taxpayers stated, in the Surplus Companies' Annual Statements, that services were provided to the Surplus Companies by affiliates, is because those statements were true, i.e., because such services were, in fact, provided. I conclude also that the reasons why the parties entered into the service agreements are set forth in those agreements. *See* Stip. ¶ J. Finally, if

[6]. The necessity of laying a foundation for taxpayers' business records was obviated in this matter pursuant to the parties' stipulation regarding the admissibility of those documents.

statements in taxpayers' books and records are inconsistent with taxpayers' position at hearing, those statements constitute written admissions against taxpayers. *See e.g.*, County Treasurer v. Ford Motor Co., 166 Ill. App. 3d 373, 519 N.E.2d 1011, 1014 (3d Dist. 1988) *aff'd*, 131 Ill. 2d 541 (1989). Those written admissions carry more weight than either WITNESS #1's or WITNESS #3's uncorroborated testimony to the contrary.

WITNESS #1 testified that the risk pools were managed by the dominant company within the risk pool. *See* Tr. pp. 76-84 (WITNESS #1). WITNESS #1's testimony reconciles taxpayers' argument that TAXPAYER did not provide strong central management over SURPLUS #3 and SURPLUS #2 with the documentary evidence of record. When considered with the service agreements, the Surplus Companies' Annual Statements, PARENT's Annual Reports and 10-Ks, and with the other evidence regarding the way taxpayers conducted business in risk pools, WITNESS #1's testimony leads to the inescapable conclusion that the dominant company in each risk pool is the company PARENT assigned to provide the centralized services each insurance company required.

The law does not require that the entity exercising centralized management authority be a member of the unitary group (*see* 86 Ill. Admin. Code § 100.9700(g)), and the facts of this matter reveal that PARENT, either through its own services, or through the services of its subsidiaries, exercised strong centralized management authority over the Surplus Companies. I conclude, after reviewing all the evidence adduced at hearing, that the INSURANCE COMPANY #6 and the Surplus Companies were functionally integrated through PARENT's (or its subsidiaries') actual exercise of strong centralized management over the Surplus Companies' business.

Issue 2

The NODs issued by the Department proposed to assess tax using a single factor apportionment formula. Stip. Ex. C (auditor's workpapers); Stip. Ex. D (protests and NODs); 35 **ILCS** 5/304(b). The auditor began his calculation by adding the reported federal income of all members of taxpayers' unitary business group. Stip. Ex. C (Auditor's Comments, pp. 1-3). The Department's auditor then calculated the denominator of the statutory combined apportionment fraction by including therein the sum of the direct premiums written everywhere by each member of the group. Stip. Ex. C (auditor's workpapers); Stip. Ex. D (protests and NODs); Department Brief, p. 39. Finally, for each taxpayer, the auditor included in the numerator the amount of that taxpayer's direct premiums written in Illinois, and then multiplied the apportionment fraction by the group's reported federal income. Stip. Ex. C (auditor's workpapers); Stip. Ex. D (protests and NODs). That method is consistent with the IITA's provisions; the denominator of the apportionment fraction for a unitary business group made up of insurance companies should include the direct premiums written everywhere by each member of the unitary business group. *See* 35 **ILCS** 5/304(b); 35 **ILCS** 5/304(e); 86 Ill. Admin. Code § 100.3320(b) (Unitary Business apportionment).

Taxpayers' argument that their Surplus Companies' income was subjected to tax in violation of Illinois law is not supported by fact or law. To begin, and while the Department included the Surplus Companies in the proposed unitary business group, the Department also determined, in this matter, that the Surplus Companies were not taxpayers. A member of a unitary business group is not necessarily a taxpayer. *See* Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700, 710-11 (1st Dist. 1995); 86 Ill. Admin. Code § 100.3320(b) (Unitary Business Apportionment).

The Department did not issue NODs to the Surplus Companies. Nor did the Department propose to assess any tax measured by including, in the numerator of an apportionment fraction, the amount of gross receipts the Surplus Companies received from premiums for surplus lines insurance written upon risk or property in Illinois. *See* 35 **ILCS** 5/304(b) (definition of "direct premiums written"). Because the Department did not issue NODs to the Surplus Companies, their business income, as a matter of fact, was never subjected to Illinois income tax.

Unsatisfied with their resulting windfall, taxpayers' additionally argue that the Surplus Companies in particular, and surplus lines insurance companies in general, have no apportionment factor as a matter of law. *See* Taxpayers' Brief, p. 49. Taxpayers rely on section 304(b) of the IITA to support that argument. That reliance, however, is misplaced. Section 304(b) of the IITA provides, in part:

> Except as otherwise provided by paragraph (2), business income of an insurance company for a taxable year shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the direct premiums written for insurance upon property or risk in this State, and the denominator of which is the direct premiums written for insurance upon property or risk everywhere. For purposes of this subsection, the term "direct premiums written" means the total amount of direct premiums written, assessments and annuity considerations as reported for the taxable year on the annual statement filed by the company with the Illinois Director of Insurance in the form approved by the National Convention of Insurance Commissioners *or such other form as may be prescribed in lieu thereof.*

35 **ILCS** 5/304(b)(1) (emphasis added).

The plain language of the statutory definition of "direct premiums written" reflects the legislature's intent to have the Department measure an insurance company's taxable income by the amount of income the company was required to report to the Director of the IDI. The last clause of the statutory definition clearly indicates that the legislature did not intend to create, in a revenue statute, the exclusive means by which all insurance companies would be required to report their income to the Director of the IDI, i.e., through an annual statement. The statutory definition cannot, in any event, be understood to mean that the legislature intended to preclude the Department from properly taxing the business income of insurance companies which, for whatever reason, do not file annual statements with the Director for the IDI.

What is clear in this case, however, is that both parties read the statutory definition in just such a way. *See* Department Brief, p. 30; Taxpayers' Brief, p. 49. By ignoring the last clause of the statutory definition, the parties accept the legally and logically unsound premise that, since the Surplus Companies were not required to file annual statements with the Director of the IDI, they cannot be deemed to have received any income from premiums for surplus lines insurance written upon property or risk in Illinois. Department Brief, p. 30; Taxpayers' Brief, p. 49.

In this matter, accepting that premise denies reality. The Surplus Companies are insurance companies (*see* Stip. Ex. B); they did receive income from premiums for surplus lines insurance written upon property or risk in Illinois (Stip. ¶ 21); and while they did not file annual statements with the Director of the IDI, the amount they received from such premiums was required to have been reported to the designee of the Director of the IDI, in a form specifically prescribed by the Director. *See* 215 **ILCS** 5/445(5).

The Director of the IDI prescribed a different form to be used to report the gross receipts surplus lines insurance companies receive from premiums for surplus lines insurance written upon property or risk in Illinois, in lieu of the annual statement used by insurance companies licensed to do business in Illinois. That form is set forth in section 445 of the Illinois Insurance Code. 215 **ILCS** 5/445(5). Pursuant to that section of the Insurance Code, the amount of gross receipts each surplus lines insurance company receives from premiums for surplus lines insurance written upon property or risk in Illinois must be reported to the Surplus Line Association of Illinois at the time each contract of surplus lines insurance is presented to that association for countersignature and approval. 215 **ILCS** 5/445(5)(d). The Surplus Line Association of Illinois is an association under the authority of the Director of the IDI, and which operates under his supervision. 215 **ILCS** 5/445.1 (*formerly* Ill. Rev. Stat. ch. 73, ¶ 1057.1 (1987)).

The report required to be filed pursuant to section 445(5) of the Insurance Code is filed by the surplus lines producer ("producer"), the entity directly regulated by the Director of the IDI. 215 **ILCS** 5/445(2); *see also*, Stip. ¶ 23. Pursuant to the Insurance Code, when a producer delivers a contract for surplus lines insurance to the Surplus Line Association of Illinois for countersignature and approval, that producer acts as the surplus lines insurance company's agent. 215 **ILCS** 5/445(10). When read in conjunction, § 445(5) of the Insurance Code prescribes the means by which surplus lines insurance companies are required to report the amount of their "direct premiums written" in Illinois, as that term is defined in § 304(b) of the IITA.

In sum, I disagree with the parties' belief that the Surplus Companies had no direct premiums written in Illinois. Notwithstanding that disagreement, I still conclude that the Department properly included the amount of the Surplus Companies' direct premiums written everywhere in the denominator of the unitary business group's apportionment fraction.

Issue 3

I hereby adopt the administrative law judge's findings of fact and conclusions of law of on the issue of whether the § 1005 penalties proposed against taxpayers should be abated.

Conclusion

The Department's determination that taxpayers' INSURANCE COMPANY #6 and their Surplus Companies comprise a single unitary business group was proper. The Department's calculation of the tax proposed to be assessed against the taxpayers identified in this matter was not improper. The section 1005 penalties proposed to be assessed shall be abated. The tax proposed to be assessed shall be revised consistent with this Final Administrative Decision. The NODs shall be finalized as revised.

Date

Kenneth E. Zehnder, Director
Illinois Department of Revenue